BLUE HORIZON
Wealth Partner AG

Strong February rally

- **On 5 March the ECB kept rates unchanged at 0.05% and announced it will start its quantitative easing program on 9 March. It will purchase euro-denominated public sector securities in the secondary market and will continue to buy asset-backed securities and covered bonds. The ECB plans to spend EUR 60 bn per month and will purchase sovereign debt until at least September 2016. This was favorably perceived by markets, and European equities in particular continued to rally.**
- **On 20 February, Yanis Varoufakis, the finance minister of Greece, had to give in vis-a-vis the European Union. Greece gained a four-month extension of the current EUR 172 bn bailout in return for more economic reforms. This agreement was just in time, as Greece's European Union loan program was due to expire at the end of February. Without an extension Greek banks might have lost the financial backstop of ECB funding, which may well have resulted in financial meltdown. Greek banks were already suffering from a steady outflow of deposits, which has been close to EUR 20 bn since the beginning of the year. However, this agreement has only bought time for Greece, which remains on a knife-edge.**
- **After the Swiss National Bank's (SNB) surprise decision to discontinue its exchange-rate floor and the initial strong appreciation, the Swiss Franc softened a bit and is trading currently at around 1.07 against the Euro, up from levels below parity. The Swiss equity index, SMI, regained most of its losses, has risen 15% since 15 January and is flat year-to-date. However, the first indications of the impact on the real economy are brutal: many companies have announced job cuts, the leading growth indicators have fallen into recession territory and February inflation fell to -0.8% YoY compared to -0.3% in December.**
- **Equity markets rallied strongly in February. The EuroStoxx50 index outperformed and gained 6.7%, followed by the Japanese Nikkei gaining 6.4%, and the US S&P500 index gaining 5.7%. The MSCI emerging markets index rose 3.1%. German 10-year government bond yields rose only slightly, by 5 basis points, whereas 10-year treasury yields rose by 33 basis points to 2.02%. Oil prices rose by 4.3% in February, while gold fell 4.5% and is trading around USD 1,200 per ounce.**
- **Our outlook remains positive for equity markets especially since growth in Europe seems to be picking up somewhat and the US economic environment is looking robust – despite some softer data recently. US treasuries yields started to rise and we think that this may continue. We also think that we are moving closer to the first Fed rate hike, which could lead to further USD strength, higher US yields and increased equity volatility. In our view, European equities will continue to outperform US equities based on cheaper relative valuations, the monetary policy divergence and the weaker Euro.**

Macroeconomics and financial markets

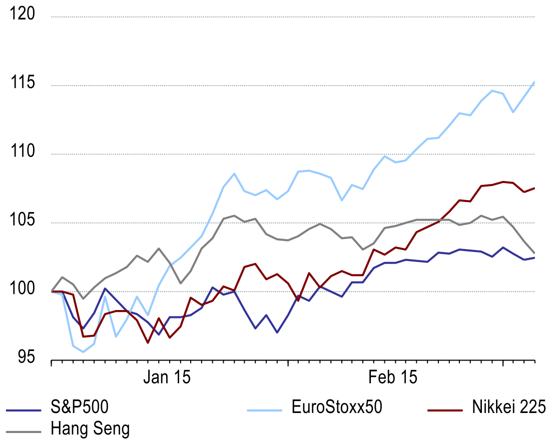
The macro data in February were somewhat mixed but have been consistent with a global economic recovery. US non-farm payrolls rose by 295k after 239k in January and the unemployment rate dropped to 5.5% from 5.7% in January. The ISM index fell to 52.9 compared to 53.5 in January. European data improved. The Eurozone PMI composite index rose to 53.5 from 52.6 and thus rose the third month in a row. We consider it very positive that expansion (PMI levels above 50) was signaled in all of the major four Eurozone economies, France, Italy, Germany and Spain.

Meanwhile the Swiss leading economic indicators worsened significantly. The Swiss PMI fell clearly below 50, to 47.3 from 48.2 in January. At the same time, the Swiss KOF business climate index dropped to -25.2 from -5.2 a month earlier.

The official Chinese Purchasing Managers' Index (PMI) inched up to 49.9 in February from January's 49.8, a whisker below the 50-point level that separates growth from contraction.

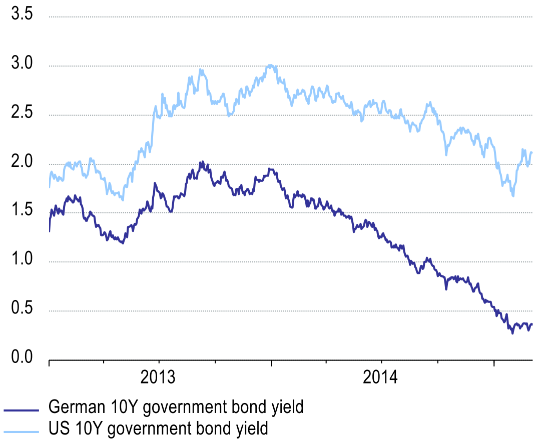
For us – and many other market observers – the development of the US bond market last year and up to today has been rather puzzling. Despite Fed tapering and the consensus view that we are moving closer to a first Fed rate hike, we have seen a strong rally of US treasuries, especially at the long end of the curve. Last year yields dropped from 3.0% to 2.19% and fell even further beginning of this year to reach 1.67% in early February. We still think that the Fed will start to hike rates for the first time in June this year, most likely by 25 basis points. Figure 3 shows that recently US capital and labor market capacity utilization has improved

Fig. 1: Major equity indices in 2015



Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner AG

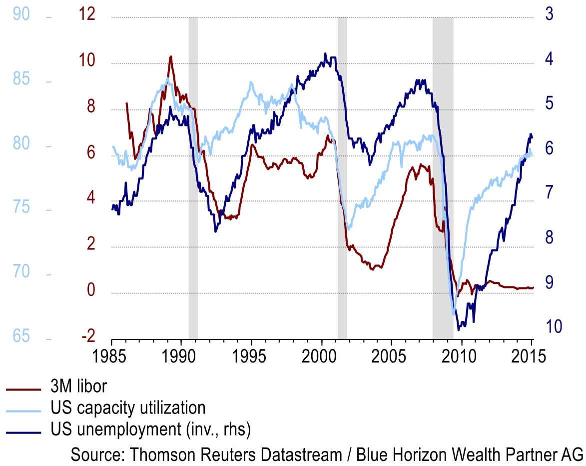
Fig 2: 10Y bond yields



Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner AG markedly. Large unused capacity, which is tantamount to high unemployment, prevents companies from investing and keeps inflation in check, or in extremis can even lead to deflation. Rising capacity utilization will eventually lead to rising prices and inflation. Figure 3 shows how capacity utilization drops during recessions (grey bands) and picks up afterwards. We also see that this time the Fed has taken much more time to raise rates in response to higher capacity utilization. Usually the combination of rising capacity utilization, which should drive inflation expectations up, and rising Fed rate hike expectations leads to rising yields.

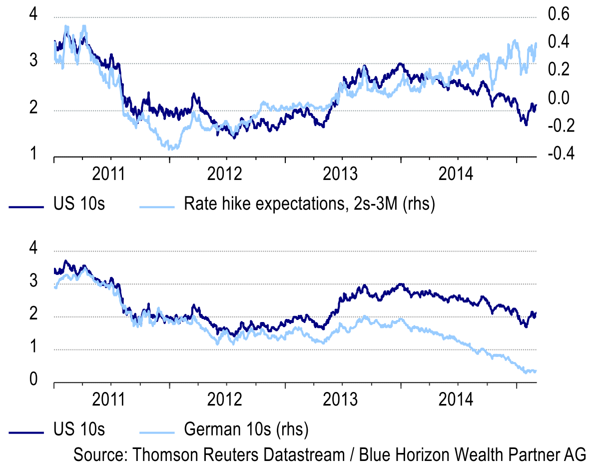
This has not happened yet. In Figure 4 we show two drivers for US 10-year yields, which we think are important for understanding the recent market development. On the one hand rising rate-hike expectations, expressed as the yield differential between 2-year rates and the 3-month libor rate, are strongly correlated with 10-year yields. This correlation broke down in 2014. The lower part of Figure 4 shows one reason for this phenomenon. International bond markets do not work in isolation but are connected. Therefore, the yield differential between major markets cannot increase by too much. The yield differential between European and US bonds has widened strongly and has reached historic heights. The higher demand for higher yielding US treasuries relative to European bonds has pushed US yields down. We think that the further development of US 10-year yields will very much depend on how the relative impact of those two forces play out. In our view, the closer we move towards the first Fed rate hike and the stronger US growth becomes, the sooner we will also see rising US bond yields. We therefore expect a yield correction and a rise of at least 3% in US 10-year bond yields this year. Since the ECB and the Bank of Japan will continue their quantitative easing programs,

Fig. 3: US recovery warrants Fed rate hikes



Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner AG

Fig 4: Drivers for 10Y US treasury yields



Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner AG global bond markets will continue to receive strong support, which will prevent a more pronounced sell-off of the US bond market.

Outlook

Our outlook for equity remains positive, especially since growth in Europe seems to be picking up somewhat and the US dynamics look robust – despite some softer data recently. US treasuries yields have started to rise and we think that this may continue. We also think that we are moving closer to the first Fed rate hike, which could lead to further USD strength, higher US yields and increased equity volatility. In our view, European equities will continue to outperform US equities based on cheaper relative valuations, the monetary policy divergence and the weaker Euro.

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